
UNIT 17 EXCHANGE RATES

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17.0 OBJECTIVES

After going through the Unit, you should be able to:

- define exchange rates;
- explain the workings of foreign exchange markets;
- assess the comparative merits of fixed and flexible exchange rate systems;
- discuss the factors influencing the determination of exchange rates; and
- describe the working of the Indian exchange rate regime as it has evolved over time.

17.1 INTRODUCTION

In this unit we discuss the financial dealings in international markets. You have read about balance of payments and exchange rates in block 3 of Course MEC 007 on international trade and finance. The current unit focuses on exchange rates and is a more in-depth study of foreign exchange markets from the perspective of financial economics.

You have been acquainted with balance of trade and balance of payments and various approaches to balance of payments. In the present unit, we get behind these theories and focus on trading of various currencies for each other. We look at foreign exchange markets as markets for financial assets and see who the actors in these markets are, what the mechanisms and devices for trade in these assets are, and how the prices of these currencies are determined.

In the subsequent section we begin with a description and analysis of the workings of foreign exchange markets. We will see that it is the biggest market for assets and round-the-clock trading takes place. In Section 17.3 we explain the workings of different exchange rate regimes, particularly, fixed and flexible, but also their variants. The foreign exchange markets function under flexible exchange rate regime. We see

the relative merits of the two systems and explore why many countries gave up the fixed exchange rate regime in 1973. Having explained different exchange rate regimes, we return in section 17.4 to the functioning of foreign exchange markets and explore how exactly exchange rates (price of one currency for another) are determined in a situation of exchange rate risk, and briefly explore some strategies to deal with these risks. Finally, we look in detail at the functioning of the exchange rate system of India: how it functions, how it has changed over the years, how exchange controls were carried out, whether total convertibility of currency is a good idea, and so on.

17.2 FOREIGN EXCHANGE MARKETS

A foreign exchange market (sometimes informally called the forex market, or denoted FEM) is a market in which different currencies are bought and sold. Foreign exchange markets arise because various countries have different monetary systems and require different currencies to buy goods, services and financial assets. So people demand different currencies since they have demand for goods, services and financial assets of other countries. Naturally, there is a supply element to this as well. To carry out these transactions between individuals and firms of different countries, there arises a demand and supply of various currencies. So related but independent markets arise, big organised markets, where *currencies themselves are all the time being traded for each other. The markets for foreign exchange facilitate foreign trade.* The forex market is not a market say, where Germans give dollars to import jeans from America. Or the American exporter of jeans says, “fine, you can pay me in Marks and I will get the marks changed to dollars in my country.” The forex market is a *cash* inter-bank or inter-dealer market. To understand how foreign exchange markets work, we need to understand the concept of exchange rates.

The exchange rate represents the number of units of one currency that exchanges for a unit of another. There are two ways to express an exchange rate between two currencies (e.g. the \$ and rupee). One can either write \$/Rs. or Rs./\$. These are reciprocals of each other. Thus if E is the \$/Rs. exchange rate and V is the Rs./\$ exchange rate then $E = 1/V$. It is important to note that the value of a currency is always given in terms of another currency. Thus the value of a US dollar in terms of Indian rupees is the Rs/\$ exchange rate. The value of the Japanese yen in terms of dollar is the \$/¥ exchange rate.

We always express the value of all items in terms of something else. Thus, the value of a litre of milk is given in rupees, not in milk units. The value of car is also given in rupee terms, not in terms of cars. Similarly, the value of a rupee is given in terms of something else, usually another currency. Hence the rupee/dollar exchange rate gives us the value of the dollar in terms of rupees.

Exchange rate quotes by participants in the forex market may be direct or indirect. A direct quote is the number of units of a local currency exchangeable for one unit of a foreign currency. An indirect quote is the number of units of a foreign currency exchangeable for one unit of a local currency. Thus indirect quote is the reciprocal of a direct quote. We know that a **currency appreciates with respect to another when its value rises in terms of the other**. The Rupee appreciates with respect to the yen if the ¥/Re exchange rate rises. On the other hand, a **currency depreciates with respect to another when its value falls in terms of the other**. The Rupee depreciates with respect to the yen if the ¥/Re exchange rate falls. Note that if the ¥/Re rate rises, then its reciprocal, the Re/¥ rate falls. Since the Re/¥ rate represents the value of the yen in terms of rupees, this means that when the rupee appreciates

with respect to the yen, the yen must depreciate with respect to the rupee. The **rate of appreciation** (or depreciation) is the percentage change in the value of a currency over some period of time. Thus, an appreciation means a decline in the direct quotation.

The foreign exchange market operates worldwide, that is, the reach of the foreign exchange market is global. The foreign exchange is by far the largest market in the world, in terms of cash value traded, and includes trading between large banks, central banks, currency speculators, multinational corporations, governments, and other financial markets and institutions. The trade happening in the forex markets across the globe currently exceeds \$1.9 trillion/day (on average). The FEM is not a physical place; rather, it is an electronically linked network of big banks, dealers and foreign exchange brokers who are all the time bringing buyers and sellers together. It is spread throughout the big and small financial centres in the world. The biggest FEM centre is London. The dealing in foreign exchange in these centres goes on round-the-clock through computers, telephones, telex, fax etc., there is a satellite-based communications network called Society of Worldwide International Financial Telecommunications (SWIFT). The FEM operates on a very narrow spreads between buying and selling prices. But since the volumes traded are very large, dealers in foreign exchange markets stand to make huge profits or losses.

The foreign exchange market has two parts: wholesale and retail. The retail market deals with exchange of bank notes, bank drafts, currency, and travellers' cheques between private customers, tourists and banks. The wholesale FEM includes the central bank, but is mainly composed of an inter-bank market in which major banks trade in currencies held in different currency-denominated bank accounts, that is, they transfer bank deposits from sellers' to buyers' accounts. A physical transfer of currency is not involved; rather, there is a bookkeeping entry among banks. The inter-bank market has two parts: direct and indirect. In the direct market, banks deal directly with each other. Banks quote buying and selling prices directly to each other and all participating banks are market makers. It is a decentralised market, characterised by double-auctions and open bids. The indirect part of the wholesale markets, banks put orders with brokers who try to match purchases and sales of different currencies. The brokers charge commission to both buyers and sellers of these currencies.

The currencies are traded on different types of markets and on different basis. There is the "spot" or cash market, where there is immediate exchange (it actually takes two days) and forward basis. Let us now understand some of the used terms, and the basis of these trades.

Arbitrage: Arbitrage, generally means buying a product when its price is low and then reselling it after its price rises in order to make a profit. Currency arbitrage means buying a currency in one market (say New York) at a low price and reselling, moments later, in another market at a higher price.

Spot Exchange Rate: The spot exchange rate refers to the exchange rate that prevails *on the spot*, that is, for trades to take place immediately. In reality, however, even payment for transactions under spot exchange rates take about two days to take place.

Forward Exchange Rate: The forward exchange rate refers to the rate which appears on a contract to exchange currencies either 30, 60, 90, 180 or sometimes even more, days in the future.

For example a corporation might sign a contract with a bank to buy DMs for dollars 60 days from now at a predetermined exchange rate (ER). The predetermined rate is called the 60-day forward rate. Forward contracts can be used to reduce exchange rate risk.

When the forward ER is such that a forward trade costs more than a spot trade today costs, there is said to be a *forward premium*. If the reverse were true, such that the forward trade were cheaper than a spot trade then there is a *forward discount*.

Hedging: A currency trader is hedging if he or she enters into a forward contract to protect oneself from a downside loss. However, by hedging the trader also forfeits the potential for an upside gain.

Check Your Progress 1

- 1) Briefly mention the structure of foreign exchange markets.
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- 2) Explain the difference between spot and forward exchange rates. What is foreign exchange premium?
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- 3) Explain the retail and the wholesale parts of the foreign exchange market.
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17.3 FIXED VERSUS FLOATING EXCHANGE RATES

To begin with, we will briefly review the balance of payments (BOP) table of a nation that you studied in the course on international economics as that will give us an idea of how exactly exchange rate regimes work. A country's BOP accounts summarises its dealings with the rest of the world. The BOP table has two main parts: (a) the current account and (b) the capital account.

The current account includes exports and imports of merchandise; exports and imports of services; inflows and outflows of investment *income*; and grants, remittances and transfers. The current account shows all flows that directly affect the national income accounts. Every transaction in the current account is an income-related flow.

The capital account includes direct investment by foreigners into the domestic economy and direct investment by citizens in foreign countries; portfolio investment, which includes net purchases of Indian securities and net lending to Indian residents; net purchases by Indian residents of foreign securities and net lending to foreigners; and changes in cash balances. The capital account shows all flows that directly affect the national balance sheet. Every transaction in the capital account is an asset-related flow.

There are two basic systems that can be used to determine the exchange rate between one country's currency and another's: a **floating exchange rates** (also called a **flexible exchange rates**) system and a **fixed exchange rates system**. Under a floating exchange rate system, the value of a country's currency is determined by the supply and demand for that currency in exchange for another in a private market operated by major international banks. In contrast, in a fixed exchange rate system a country's government announces, or decrees, what its currency will be worth in terms of "*something else*" and also sets up the "*rules of exchange*." The "*something else*" to which a currency value is set and the "*rules of exchange*" determines the type of fixed exchange rate system, of which there are many. For example, if the government sets its currency value in terms of a fixed weight of gold then we have a gold standard. If the currency value is set to a fixed amount of another country's currency, then it is a reserve currency standard.

When a country has a regime of flexible exchange rates, it will allow the demand and supply of foreign currency in the exchange rate market to determine the equilibrium value of the exchange rate. So the exchange rate is market determined and its value changes at every moment in time depending on the demand and supply of currency in the market.

Some countries (for e.g. China, Mexico and many others), instead, do not allow the market to determine the value of their currency. Instead they "peg" the value of the foreign exchange rate to a fixed parity, a certain amount of rupees per dollar. In this case, we say that a country has a regime of **fixed exchange rates**. In order to maintain a fixed exchange rate, a country cannot just announce a fixed parity: it must also commit to defend that parity by being willing to buy (or sell) foreign reserves whenever the market demand for foreign currency is greater (or smaller) than the supply of foreign currency.

We have seen that banks are big players in the foreign exchange markets. Changes in flexible exchange rates are brought about by banks' attempts to regulate their inventories. However, these inventory changes reflect more basic underlying forces of demand and supply that come from the attempts of households, firms and financial institutions to buy and sell goods, services and assets across nations. Changes in exchange rates, in turn, modify the behaviour by households, firms and financial institutions. Under a fixed.

The forex market that we studied in Section 17.2 was hugely expanded in 1971, when the fixed exchange rate system of the Bretton Woods began to be abandoned and floating exchange rates began to appear. Under the fixed exchange rate system there was no inter-bank markets for national currencies, no dealers carrying out

huge transactions. The Bretton Woods agreement prevented speculation in currencies. The Bretton Woods Agreement was set up in 1945 with the aim of stabilizing international currencies and preventing money fleeing across nations. This agreement fixed all national currencies against the dollar and set the dollar at a rate of \$35 per ounce of gold.

If we consider capital flows, then under a flexible exchange rate, capital movements affect the domestic economy, by having expenditure-switching effects income, output and employment, and they can also change domestic prices. Under a fixed exchange rate, capital movements do not affect the domestic economy directly, but may affect it indirectly by altering the money supply, interest rates, and so on. In fact, with high capital mobility, the central bank is unable to control the money supply and thus loses control of the domestic interest rates.

Let us now look at the relative merits of fixed and flexible exchange rates and see when it is better to have a flexible rate regime. What is the case for and against flexible exchange rates? Basically, a flexible exchange rate regime, the case for which was always quite popular among many economists and became attractive to policymakers of many countries in the wake of currency crises in the late 1960s in Western countries, is a system where the central bank does not intervene in the foreign exchange markets to fix rates, is supposed to automatically ensure exchange rate flexibility. Moreover, this system is supposed to confer other benefits as well. Let us look at these putative benefits now.

First, under flexible rates, there is monetary policy autonomy. If central banks were no longer required and obliged to intervene in currency markets to fix exchange rates, governments would be able to use monetary policy to reach internal and external balance. No country would be able, moreover, to export inflation or unemployment to other nations. Secondly, under a system of flexible exchange rates, the underlying asymmetries of power prevalent under fixed exchange rate system, like that of the US under the Bretton Woods arrangement, would vanish, and powerful countries like the US will not be able to set world monetary conditions all by themselves. Finally, and this is related to the first point above, under a flexible exchange rate regime, the exchange rates would act as automatic stabilisers. Even in the absence of an active monetary policy, the quick adjustment of market determined exchange rates would help countries maintain internal and external balance in the presence of fluctuating aggregate demand.

What is the case against floating exchange rates? The experience with floating exchange rates has not been uniformly nice, so that some scepticism about floating exchange rates have arisen. The following points are put forward as reasons for lack of faith in flexible exchange rates. First, since central banks are freed from the obligation to fix exchange rates, it is feared that some indiscipline may creep in, and they may embark on an inflationary policy. The discipline imposed on them would be lost. Secondly, flexible exchange rates allow speculators to step in, and speculation on changes in exchange rates, it is feared, could lead to instability in foreign exchange markets, and this instability, in turn, might have negative effects on countries' external and internal balance. Moreover, floating exchange rates could cause more disruptions to a country's home money markets than fixed exchange rates. Third, floating exchange markets can make relative international prices more predictable and hence damage international trade and investment.

A floating exchange rate regime indicates that coordination on adjustment is less than under fixed exchange rate regime, which had an architecture like the Bretton

Woods system. Under flexible exchange rates, countries might follow a policy without thinking of possible beggar-thy-neighbour effects. The poor countries might be hurt by competitive currency practices. This is the fourth point against floating exchange rates. Finally, proponents of flexible exchange rates claim that a flexible exchange rate regime provides greater autonomy to policymaking by countries. Sceptics of floating exchange rate regimes claim that such autonomy is largely illusory. Fluctuations in exchange rates would have such large and wide-ranging macroeconomic effects that central banks would be forced to intervene in foreign exchange markets, even though they may not have a formal commitment to peg. Floating exchange rates would thus increase the uncertainty without giving macroeconomic policy greater liberty.

How does the central bank intervene in the foreign exchange market under fixed exchange rates? In technical terms, the central bank intervenes in the foreign exchange rate market by selling foreign currency. Therefore, a country can defend a fixed exchange rate parity that differs from the equilibrium exchange rate (that would hold under flexible rates) only as long as it has a sufficient amount of foreign exchange reserves to satisfy the market excess demand for the foreign currency. If the country runs out of foreign exchange reserves, the fixed parity becomes unsustainable and the central bank will be forced to give up the defence of the currency: the exchange rate will depreciate to its flexible rate value or it will lead to developing of the black market for buying and selling of foreign exchange (as has been the case in many countries as well as in India, before 1993).

Note also that foreign exchange rate intervention affects the money supply of the country under consideration. In fact, when the central bank intervenes to defend its parity, it is selling foreign exchange currency in the market; in exchange of its sale of foreign currency the central bank receives domestic currency that is therefore taken out of circulation: investors pay with domestic currency their purchase of foreign currency from the central bank. In this sense, foreign exchange intervention taking the form of a sale of foreign reserves has an effect on the money supply that is identical to an open market sale of government securities; in both cases, the money supply is reduced. Therefore, foreign exchange rate intervention taking the form of a sale of foreign reserves leads to a reduction in the money supply. Conversely, foreign exchange rate intervention taking the form of a purchase of foreign reserves leads to an increase in the money supply.

We discussed in Unit 13, in the Section on the money market equilibrium how monetary policy affects the money supply and the interest rate of an economy. *Open market operations* are the standard instrument way in which a central bank controls the money supply and interest rates. We should consider now the effects of such open market operations when the economy is open. Open market operations have very different effects under flexible and fixed exchange rate regimes.

Consider first the effect of an open market purchase of government bonds under flexible exchange rates. Under flexible rates, the central bank does not intervene to defend its currency when market pressures lead to its weakening. Therefore, an open market purchase of domestic bonds will lead to an increase of the money supply. In turn, this increase in the money supply will cause a reduction of the domestic interest rate (please refer to Unit 13). What will be the effect of this monetary expansion on the exchange rate? The exchange rate will depreciate: in fact, as interest rate at home are now lower than before, investors will want to reduce their holding of domestic bonds and increase their holding of foreign bonds that are now relatively

more attractive in terms of their return. Therefore, investors will try to sell domestic bonds, buy foreign currency and buy foreign bonds. The attempt to sell domestic currency in order to buy foreign bonds will, in turn, cause a depreciation of the domestic currency.

The effects of the open market purchase of bonds on the money supply under flexible exchange rate will be identical to the one obtained in a closed economy: the money supply will increase and interest rates will fall. The increase in the money supply and reduction in the interest rate will lead to a depreciation of the domestic currency but since the central bank does not defend the current parity under flexible exchange rates, no foreign reserve intervention will occur and foreign reserves will remain the same as before: then, the exchange rate will depreciate.

One key advantage of fixed exchange rates is the elimination of exchange rate risk, which can greatly enhance international trade and investment. A second key advantage is the discipline a fixed exchange rate system imposes on a country's monetary authority, likely to result in a much lower inflation rate.

Some have argued that it is impossible to have simultaneously a combination of: full capital account convertibility, domestic monetary policy interdependence and a stable currency. Suppose a country wants capital account convertibility. Then it has to give up the latter two. Let us briefly mention some of the exchange rate arrangements that obtain in practice, that are not fully flexible but some variants of flexible exchange rates. These are called intermediate exchange rate systems. There are the systems of "crawling peg", mixed flexible and fixed rates", "target zone", and "managed or pegged or dirty float". When the range of deviations is allowed to be wider, say 2.5 or 3 per cent, it is known as the wider band system. It is also known as a target zone system. In practice, most countries opt for fixed pegs or crawling pegs, or managed floats. No country at present seems to favour fixed exchange rates. However, an entirely freely floating exchange rate system also appears to be rare.

Check Your Progress 2

- 1) Explain how floating exchange rates work.

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- 2) How does the Central Bank of a country intervene to control the money supply in the presence of fixed exchange rates?

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- 3) Briefly state the basic structure and components of a balance-of payments accounts table.

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17.4 DETERMINATION OF EXCHANGE RATES

When we study the determinants of exchange rates, we must distinguish between long run determinants and short run because the determinants in the two situations are different and exchange rates are more volatile.

In the long run, the exchange rates are determined by the movement of the important variables, called the fundamentals, like price and real incomes in different countries. The long run exchange rates between two currencies are determined by supply and demand. There are other factors that affect the exchange rates by shifting the demand and supply curves. An important such factor is real income in an economy, which reflects the productivity of the country's resources. Change in real income at home relative to that abroad will shift the demand and supply curves in the foreign exchange market. In the long run the equilibrium exchange rate is determined by the intersection of supply and demand curves. Shifts in the supply curve or demand curves are brought about by variables such as real income and price levels. Another important long-run determinant of exchange rates is the domestic price level compared to that abroad. A basic result is that all things remaining equal, an increase in a country's price level will lead to long-run depreciation of the country's currency. The third factor influencing exchange rates are tariffs, trade barriers and preferences. These affect the ability of domestic residents to purchase foreign goods and hence affect demand for foreign currencies. This altered demand changes the exchange rate. Of course, the same kind of effect works for foreign consumers to buy domestic goods and services. Finally, it is suggested that interest rates prevailing in the domestic financial markets as well as in foreign markets influence long run exchange rates. However, if interest rate parity holds, interest rates affect exchange rates mainly in the short run. If interest rates in country A are higher relative to those in country B, holders of deposits in country B's currency in B's domestic economy find it worthwhile to convert the currency of B into currency of A. this raises the demand for A's currency. Thus a rise in interest rate in A leads to a decrease in the currency of A in the domestic market.

We have put forward several determinants of exchange in the long run. There is a simpler theory, called **purchasing power parity (PPP)** that asserts that in the long run the exchange rate between two currencies is determined only by differences in the price level in the two countries. The idea of PPP derives from the law of one price, which states that two identical goods within a same market must sell at the same price. Violations of the law will be corrected by consumers buying only the cheaper one. Applied to international economics, the law of one price asserts that an identical good must sell at the same price expressed in the same currency. The law of one price applies to identical goods, but has extended to purchasing power parity, which is a relationship not between prices of identical goods but between price

levels in different countries. Purchasing power parity states that the price level in the domestic economy times the exchange rate (expressed as foreign currency per unit of domestic currency) equals the price level in a foreign country:

$$P_d \times e = P_f$$

where P_d is price level in the domestic economy, P_f is price level in a foreign country, and e is the exchange rate.

When PPP holds, the domestic currency has the same purchasing power at home and in any other country. PPP also implies that a foreign currency will depreciate if the country's price level rises relative to the foreign price level and appreciate if the foreign price level rises relative to the country's own price level. The question is, does the PPP hold in reality. The empirical evidence seems to suggest that it does not always hold particularly in the short run. The reason is that there are substantial transaction costs. Moreover, goods are really not identical across markets and countries. There are also substantial amount of non-traded goods. But the PPP does a good job of explaining the *direction* of change in the exchange rate.

Now let us try to look at the determinants of exchange rates in the short run. In the short run, there is tremendous volatility and fluctuations in exchange rates. The determinants of exchange rates in the long run do not explain the fluctuations in exchange rates in the short run. Since in modern times foreign exchange markets are linked with computers, banks and other dealers can very quickly convert domestic currency into foreign currency, they can very quickly buy at a lower price in one market and try to sell in the same or other market very soon. Thus in the short run, exchange rates are largely determined by expectations of future exchange rates.

Banks and other traders of currency are continually seeking out profit opportunities. To them foreign bank deposits are close substitutes for deposits in foreign currency because these can be easily converted from one currency to another via the foreign exchange market. So these dealers are constantly monitoring movements of interest rates and exchange rates to determine the most profitable kind of deposits to hold. If Ee_{t+1} denotes the trader's expectations of the future exchange rate, and e_t the current exchange rate, then the expected rate of return of holding foreign deposits is:

$$R_f = i_f - \frac{(Ee_{t+1} - e_t)}{e_t}$$

If i_d is domestic interest rates, traders are continually comparing i_d with R_f , if the latter is greater, then the traders will like to hold deposits abroad. They switch continually across countries to maximise their expected returns, and this goes on until in equilibrium

$$R_f = i_d = i_f - \frac{(Ee_{t+1} - e_t)}{e_t}$$

This relation is called **interest rate parity**, because it depicts the equality of interest rate on domestic deposits and *expected* return on foreign deposits. When interest rate parity holds, traders cannot profit by switching currency holdings, and this effectively determines the short run current exchange rate e_t .

The interest rate parity relation shows that R_f depends not only on e_t and I_f but also

on traders' expectations about future exchange rates E_{t+1} . traders are continually updating this expectation based on all the relevant current information. Hence, short run exchange rates are hard to predict and arise mainly due to traders' minute-to-minute changes in expectations that take place as new information becomes available.

17.5 AN ILLUSTRATION: THE EXCHANGE RATE SYSTEM OF INDIA

It is interesting to look at a case study of a country like India for several reasons: first it is a small country in terms of imports and exports as a proportion of world imports and exports. Secondly, it is a developing nation that had an experience of being colonised. Thirdly, the government intervened heavily in the foreign exchange market, and over the last 15 years or so, there has been liberalisation, whereby the government has liberalised the exchange rate policy. Finally, and related to the above point is the fact that India has changed its exchange rate regime from an earlier fixed one to a new one. Also the exchange control system has changed. Let us now study the exchange rate mechanism and system operative in India and explore how it has undergone changes over the years.

Before the IMF came into being, the rupee was linked to the pound sterling. In India, there was a sterling exchange standard till 1947. When India became a member of the IMF, the rupee-pound sterling link was severed, and the rupee's par value came to be expressed in gold. Since in the Bretton Woods system, gold was linked to the US dollar, the dollar in effect became the intervention currency. But the exchange value of the rupee in terms of the pound sterling was not disturbed. When the pound was devalued in 1949, the rupee was devalued to an identical extent. However, the devaluation of the rupee in 1949 and later in 1966 led to the reduction of the par value of the rupee in terms of gold.

In 1971, after the USA left the fixed exchange regime, the rupee-pound rate was allowed to fluctuate with reference to the par value of the rupee in terms of the US dollar, even though the gold parity as well as the US dollar parity of the rupee as fixed in June 1966 remained unchanged. This arrangement lasted only from August to December 1971. In December 1971, the pegging of the exchange rate of the rupee to the dollar was given up and a central rate of the rupee as an average of the buying and selling rates of the RBI for the pound came to be adopted. This arrangement continued till September 24, 1975 when the rupee was de-linked from the pound sterling. The rupee was pegged to gold and sterling till 1966, to gold and dollar from 1966 to 1971, and again to sterling from 1971 to 1975.

From September 25, 1975, the exchange value of the rupee was determined with reference to the daily exchange rate movements of a selected number of currencies of countries that were major trading partners of India. The selection of the currency units and the weights to be assigned to them was left to the discretion of the RBI, subject to the approval of the government. Thus, the rupee came to be linked to an undisclosed basket of currencies. It was undisclosed in order to discourage speculation in the foreign exchange market. Even when the rupee was pegged to the basket of currencies, the pound sterling continued to be the currency of intervention. Under this arrangement, the value of the domestic currency (rupee) with respect to the intervention currency (pound) was changed in line with the movements in the weighted average of the value of the trading partners' currencies *vis-à-vis* the intervention currency.

India chose basket peg over single-currency peg to give stability to the exchange rate. Pegging to a single currency injects greater volatility to the exchange rate emanating from the fluctuations in the currency to which the pegging has been done. However, in reality, this stability seems to have been absent as the rupee was adjusted vis a vis the pound 3 times in 1975, 13 times in 1979, 71 times in 1981, 154 times in 1985, 200 times in 1988, and 252 times in 1998-90. Over the entire period that the basket-peg system was in operation, the RBI gave daily announcements of its buying and selling rates to authorised dealers for transactions.

The basket-peg was given up when India liberalised her economy in 1991. The basket-peg arrangement was replaced by the system of “Liberalised Exchange Rate Management” (LERM) or the Dual Exchange Rate System in March 1992. The dollar replaced the pound sterling as the intervention currency. The LERM was a tentative shift towards a flexible exchange rate regime. Under LERM, or the Dual Exchange Rates, there were two exchange rates, one officially determined and one market determined. Authorised dealers had to surrender 40 per cent of all current account receipts to the RBI at the official rate, while the remaining 60 per cent could be traded at the market rate. In February 1993, India moved to a floating exchange rate regime, with the introduction of the “Unified Exchange Rate System “ (UERS). As part of the UERS, trade account convertibility of the rupee was introduced on March 2, 1993. Since then convertibility has been extended in scope and from August 20, 1994, convertibility of many current account transactions was introduced. However, there is still some scepticism in official circles over full capital account convertibility. Thus India now has a floating exchange rate system with intervention by the authorities to moderate changes in the exchange rate and to avoid undue speculation. RBI occasionally purchases and sells currencies to ensure that market operations and exchange rate operations are smooth and not speculative in nature.

India thus had a basket peg system from September 1975 to March 1992, a dual exchange rate system from March 1992 to February 1993, and a floating exchange rate system thereafter. The pound was the intervention currency from 1966 to 1992 and subsequently the dollar became the intervention currency. Some subsequent developments may be mentioned. In August 1993, the direct quotation system was abolished. In October 1995, the RBI discontinued quoting its buying and selling rates. In April 1997, the RBI permitted banks to borrow and invest in foreign markets. There has also occurred a liberalisation of gold policy. This has had a significant impact on the Indian forex market. This policy has created new channels of gold import, which led to shrinking of difference in the domestic and international prices of gold. Consequently, the unofficial market in foreign exchange all but disappeared.

To end this section, let us now look at the process of Central Bank intervention, and the exchange control system that has been in operation in India. The RBI has the authority to enter into foreign exchange dealings both on its own accord and on behalf of the government. Foreign exchange intervention in India is the joint responsibility of the RBI and the Ministry of Finance. The RBI, however does not deal in foreign exchange directly with the public. Rather, it does so through authorised dealers (ADs). The public has to carry out transactions in foreign exchange through authorised dealers, of whom at present there are about 85. These authorised dealers have formed an organisation called the Foreign Exchange Dealers’ Association of India (FEDAI) since 1958, which determines the rules for the fixation of commission and other charges. Before this till 1958, the RBI exercised control over foreign exchange dealings through the Exchange Banks’ Association.

The RBI determines the exchange rate regime and monitors and supervises the foreign exchange market. Previously, the RBI used to establish the day's buying and selling rate of the rupee in terms of pound sterling at the beginning of the day. During the fixed exchange rate regime, in order to maintain the prevailing exchange value of the rupee, the RBI was obliged to buy and sell foreign exchange against rupee on demand without limit at fixed rates. Since 1947, after Independence, the RBI was to buy and sell any currency; before 1947, it was only pound sterling. But even after 1947, in actual practice, the RBI did not buy and sell any currency other than the pound for a long time, because the pound was the intervention currency till 1971. Dollar purchases were started on October 9, 1972, and dollar sales from February 2, 1987. Deutsche mark and yen purchases were started in 1974.

Till February 1992, the RBI used to buy US dollars, pound sterling, deutsche mark, and yen spot and forward for varying maturities up to 12 months, but sold only dollar and sterling on spot basis. From March 1992, the dollar replaced the pound sterling as the intervention currency.

There has been in operation an exchange control system that arose in the late 1930s when India was not only a colonised economy but was in the midst of World War II and controls were imposed in many areas of the economy. Exchange control was first imposed under the Defence of India Act, 1939. Later, a statutory basis was given to it by the Foreign Exchange regulation Act, 1947. This Act was replaced by a more comprehensive, forceful and expanded legislation, the Foreign Exchange Regulation Act, 1973, which came into force on January 1, 1974. This was replaced later by the Foreign Exchange Management Act. The exchange control was related to and complemented by the trade controls imposed by the Chief Controller of Imports and Exports in terms of Imports and exports (Control) Act, 1947. Exchange control was relaxed in the 1990s after liberalisation.

Check Your Progress 3

- 1) What are the main determinants of exchange rates in the short run?
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- 2) Write a brief note on the exchange rate arrangement in India.
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- 3) What do you understand by currency convertibility? Do you think India should have full capital account convertibility?
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17.6 LET US SUM UP

In this unit, we studied the functioning of foreign exchange markets. We looked at this financial market that is the biggest financial market in the world. We saw who the main actors are, and how transactions take place. We then looked at the question of whether fixed exchange rates are better than flexible ones and looked at different arrangements. We observed that most nations are now opting for flexible exchange rates, and we explored why. We then looked at the determination of exchange rates with spot and forward trading, and the presence of risks.

We finally looked as an illustration the case of exchange rate regime in India. We saw how the earlier fixed rate regime was replaced by the flexible rate system. We learnt about the exchange control system that was in operation and that has been modified.

17.7 KEY WORDS

Arbitrage	: Arbitrage, generally means buying a product when its price is low and then reselling it after its price rises in order to make a profit. Currency arbitrage means buying a currency in one market (say New York) at a low price and reselling, moments later, in another market at a higher price.
Currency Appreciation	: A currency <i>appreciates</i> with respect to another when <i>its value rises</i> in terms of the other.
Currency Convertibility	: Under full currency convertibility, institutional exchange arrangements exist whereby people can freely and without limit exchange without limit domestic currency for any foreign currency or gold at the market rate of exchange
Exchange Rate	: The exchange rate represents the number of units of one currency that exchanges for a unit of another.
Forward Exchange Rate	: The forward exchange rate refers to the rate that appears on a contract to exchange currencies either 30, 60, 90, 180 or sometimes even more, days in the future.
Interest Rate Parity	: This occurs when interest on domestic deposits equals the expected return on foreign deposits. When interest rate parity holds, traders cannot profit by switching currency holdings.
Purchasing Power Parity	: It is a principle according to which states that the equilibrium exchange rate makes the cost of foreign and domestic goods expressed in the same currency equal.

Spot Exchange Rate

: The spot exchange rate refers to the exchange rate that prevails *on the spot*, that is, for trades to take place immediately. In reality, however, even payment for transactions under spot exchange rates take about two days to take place.

Exchange Rates

17.8 SOME USEFUL BOOKS

Coyle, B.(2001) *Foreign Exchange Markets*, Glenlake Publishing Company, Chicago.

Kenen, Peter B. (1994) *The International Economy*, Cambridge University Press, Cambridge.

MacDonald, Ronald (1988) *Floating Exchange Rates: Theories and Evidence*, Routledge, London.

17.9 ANSWERS/HINTS TO CHECK YOUR PROGRESS EXERCISES

Check Your Progress 1

- 1) See Section 17.2 and answer.
- 2) See Section 17.2 and answer.
- 3) See Section 17.2 and answer.

Check Your Progress 2

- 1) See Section 17.3 and answer.
- 2) See Section 17.3 and answer.
- 3) See Section 17.3 and answer.

Check Your Progress 3

- 1) See Section 17.4 and answer.
- 2) See Section 17.5 and answer.
- 3) See Section 17.5 and answer.

UNIT 18 RISE AND FALL OF BRETTON WOODS INSTITUTIONS

Structure

- 18.0 Objectives
- 18.1 Introduction
- 18.2 World Bank
 - 18.2.1 Lending Operations of World Bank
- 18.3 International Monetary Fund (IMF)
 - 18.3.1 Special Drawing Rights (SDRs)
 - 18.3.2 IMF – World Bank Harmony
- 18.4 Achievements of Bretton Woods Institutions
- 18.5 Failures of Bretton Woods Institutions
- 18.6 Rationale in Era of Globalisation and Suggestions
 - 18.6.1 Rationale
 - 18.6.2 Suggestions
- 18.7 International Development Association (IDA) and International Finance Corporation (IFC)
 - 18.7.1 Working of IDA
 - 18.7.2 Working of IFC
- 18.8 Let Us Sum Up
- 18.9 Key Words
- 18.10 Some Useful Books
- 18.11 Answers/Hints to Check Your Progress Exercises

18.0 OBJECTIVES

After reading this Unit, you will be able to:

- discuss the genesis and rationale of Bretton Woods Institutions;
- describe their operations and working;
- list the objectives and functions of these institutions;
- assess for yourself how far these institutions have achieved their objectives;
- identify the shortcomings of these institutions; and
- give suggestions regarding ways to make these institutions compatible with on-going process of globalisation.

18.1 INTRODUCTION

In 1944, as the Second World War neared its end, a conference was convened by the victorious countries in Bretton Woods, in the United States. It was here that the World Bank and the International Monetary Fund were born – in the hope that they would provide the foundation of a peaceful and prosperous future for the world.

Sixty years later, these two multi-lateral institutions also known as Bretton Woods Institutions (BWIs) occupy a dominant position in the global political economy, but they are the target of powerful attack – both in the streets and in media. And in course of those 60 years, they have been joined by a whole range of other multilateral institutions. In the Course of this period, a great deal had changed. The anniversary of the World Bank and IMF was met with a ‘Fifty Years in enough’ campaign. While some people see those institutions, and the multilateralism they promote, as important role in the elimination of world poverty others see them not as a solution, but recent years, been greatly increased public attention and criticism of the multi-lateral institutions.

18.2 WORLD BANK

The World Bank group is a partner in opening markets and strengthening economies. Its goal is to improve the quality of life and expand prosperity for people every where, especially the world’s poorest.

The World Bank group of institutions includes as follows:

- 1) **The International Bank for Reconstruction and Development (IBRD)** founded in 1944 in the single developing countries and a major catalyst of similar financing from other sources.
- 2) **The International Development Association (IDA)** founded in 1960, assists the poorest countries by providing interest free credits with 35 to 40 years maturities.
- 3) **The International Finance Corporation** supports private enterprise in the developing countries by providing interest free credits with 35 to 40 years maturities.
- 4) **The Multilateral Investment Guarantee Agency (MIGA)** offers investors insurance against non-commercial risk and helps developing country governments to attract foreign investment.
- 5) **The International Centre for the Settlement of International Disputes (ICSID)** encourages the flow of foreign investment to developing countries through arbitration and conciliation facilities.

Over the years, the World Bank has made two significant departures in its policy of lending; it changes its policy of lending to government and public sector and concentrated on private sector, and it changed its approach from a project based lending to sector-based lending.

18.2.1 Lending Operations of World Bank

Resources of the Bank consist of the capital and borrowings. The capital of the bank is contributed by its 184 member-countries. Besides, the Bank raided capital by sale of bonds on the World’s capital markets where the Bank is the World’s largest non-government borrower in the international market.

The Bank leads only to under-developed countries, and even among them it “graduated” its borrowers when per capita income reaches a threshold. The Bank marked or facilitated loans in one or more of the following ways:

- By making or participating in direct loans out of its own funds; or
- Out of funds raided in the market; or

- By guaranteeing the whole or part loans made by private investors through the investment channels.

In recent years, the Bank also moved into “co-financing”, with governments and private banks and co-financiers with projects. However, since the mid-1980s when the debt crisis occurred, co-financing has become less popular with commercial banks, but governments have made much use of the Bank’s expertise by putting a part of their foreign aid into the projects.

Before granting or guaranteeing a loan the Bank considers the following matters:

- i) The project for which the loan is asked has been carefully examined by a competent committee as regard the merit of the proposals.
- ii) The borrower has reasonable prospects for repayment;
- iii) The loan is meant for productive purposes; and
- iv) Except in special circumstances, the loan is meant to finance foreign exchange requirement of specific projects or reconstruction and development.

The amount of the loan granted by the Bank should not exceed 100% of its total subscribed capital and surplus. Rate of interest is determined by adding a spread of ‘1/2 of %’ over the ‘pool rate’ of outstanding borrowing of the Bank. In lending for development projects in developing countries, the Bank estimates a likely rate of return; this must be above a minimum 10 per cent for the project to go forward.

18.3 INTERNATIONAL MONETARY FUND (IMF)

The important objectives before the Fund presently are as follows:

- To promote international cooperation;
- To facilitate the expansion and balanced growth of international trade;
- To addit in establishing a multilateral systems of payments for current transactions between member countries as well as in eliminating foreign exchange restrictions that hamper the growth of world;
- To make available to the member countries the IMF’s general resources on a temporary basis to enable them to correct BOP difficulties without resorting to measures that would harm national or international prosperity;
- To shorten the duration and lessen the degree of disequilibrium in the BOP of member countries.

The basic functions of the IMF are as follows:

- i) To lay down ground rules for conduct of international finance;
- ii) To provide short and medium-term assistance for overcoming short-term BOP deficits; and
- iii) Creation and distribution of reserved in the form of special Drawing Rights (SDRs).

The Fund has 184 member-countries accounting for more than 80 per cent of the total world population and 90 per cent o the world trade. Each member-country contributes a certain sum of money called a quota subscription as a cost of membership fee.

Quota represents the subscription by a member-country to the capital fund of the IMF. Quotas are fixed for each country taking into account such factors as (i) GNP

of the country, (ii) current account transactions, (iii) variability of current receipts, and (iv) official reserves.

Each member country contributes 25 % of its quota in the form of SDR or foreign exchange and 75% in the country's own currency. Quoted serve various purposes:

- They determine the member's contribution to the Fund's resources which form a pool of money that the IMF can draw to lend to members in financial difficulty.
- They determine the voting powers of the members (each country has 250 basic votes plus one additional vote for each SDR 1,00,000 of quota).
- They are the basis for determining how much the contributing member can borrow from the IMF.
- They are the basis for determining how much each member receives from the IMF in periodic allocation of SDRs.

Overall, each member's quota is the most fundamental element in its financial relationship with the IMF.

IMF provides temporary assistance to member countries to tide over BOP deficits. When a country requires foreign exchange, it tenders its own currency to the IMF and gets the foreign exchange. This is known as drawing from the Fund. When the BOI condition of the country improved, it should repurchase its currency from the Fund and repay the foreign exchange.

Ordinarily, for a member-country, a first borrowing or drawing is virtually automatic and within string. A country simply called for the return of its original 25 per cent share (called the 'reserve tranche', tranche being French for 'slice') paid in hard currency. After that it may borrow four more credit tranches (each 25 % of its quota) in each of the subsequent four years. Thus, a member can borrow, almost automatically, upto 125% of its quota in a period of five years. Beyond this, if the IMF approves a member's plan for economic reforms, the member can borrow a further 90 per cent of its quota annually for three years under the 'enlarged access' policy. This limit can be raised to 100 per cent of the quota. All told, a member country can seek foreign exchange upto a cumulative upper limit of 400 to 440 per cent of its quota.

The purchase of the first or the reserve tranche is free of any strings or conditions. But obtaining the second, third and fourth credit tranches and money from the extended access policy involves an ever greater degree of IMF supervisions, including substantial consultation with the officials of the Fund and a visit by the IMF financial teams. Typically, the IMF will require as prerequisites for borrowing cutback in budget deficit including subsidies to various sectors of the economy, reduction in the rate of monetary expansion, measures to restrain wages and prices, devaluation of an overvalued exchange rate, and some action to make the price system reflect costs more accurately and some steps to encourage exports. These are known as 'conditionalities' attached to assistance from the IMF. The conditionalities have proved to be the most controversial aspect of IMF operation in recent years. The major complaints of the borrowers against the IMF conditionalities are that it has become tougher, with stiffer norms towards borrower's domestic policies and that low income groups within a country bear the burnt of the adjustment.

18.3.1 Special Drawing Rights (SDRs)

SDRs are entitlement granted to member countries enabling them to draw from the IMF apart from their quota. It is similar to a bank granting a credit limit to the

customer. When SDRs are allocated, the country's Special Drawing Account with the IMF is credited with the amount of the allotment.

SDR is not a currency. It is merely an asset created out of book entries. As such it is an independent reserve asset. The volume of SDRs can be increased or decreased according to the reserve needs of the international liquidity. Initially, the value of one SDR was equal to a specific quantity of gold (which equalled the value of 1 US Dollar) and provided with an absolute gold value guarantee. That is why SDRs were popularly known as 'Paper Gold'. Later, the value of SDR was linked to a basket of five currencies. The basket is reviewed every five years. It currently, consists of the Euro, the Yen, the Pound sterling and the US Dollar. When a member country utilises SDRs in holding would be less than the allocation. SDRs can be used directly among the members. A country may swap SDRs with another country to acquire a currency it desires. SDRs may be utilised to pay charges to IMF. SDR may be utilised to pay charges to IMF. SDR has gained importance both as a reserve asset and as a Unit of settlement of international transactions. Some international banks time deposits designated in SDR. Some countries have pegged their currencies to SDR.

18.3.2 IMF-World Bank Harmony

Bretton Woods institutions work in tandem. World Bank BOP support is not available with a Fund Programme, while a Fund Programme cannot be finalised without the prior negotiation of BOP support from the World Bank and from bilateral donors to fill the programmed resources gap. The bilateral donors do not commit funds until negotiations with the World Bank have been concluded. Whereas the IMF sets the macro-economic guidelines and targets of a programme, the World Bank imposed a list of neo-liberal macro-economic policy reforms on the borrowing country.

How Does the IMF Differ From The World Bank?

Table 18.1 below summarises the basic differences among the two institutions.

Table 18.1: Distinct Roles of the IMF and the World Bank

International Monetary Fund	World Bank
Oversee the international monetary systems and promotes international monetary cooperation.	Seeks to promote economic development and structural reforms in developing countries.
Promote exchange stability and orderly exchange relations among its members.	Assists developing countries by providing long-term financing of development projects and programmes.
Assists members in temporary BOP difficulties by providing them with the opportunity to correct maladjustments in their BOP.	Provides special finance assistance to the poorest developing countries through the IDA.
Supplements the reserves of its members by allocating SDBs if there is a long-term global need.	Stimulates private enterprise in developing countries through its affiliate, the International Finance Corporation.
Draw its financial resources principally from the quota subscriptions of its members.	Acquires most of its financial resources by borrowing on the international bond market.

18.4 ACHIEVEMENTS OF BRETTON WOODS INSTITUTIONS

Some of the important *achievements* of the BW Institutions can be summarised as follows:

- 1) International reserves have increased substantially, providing a larger borrowers, halt now hold reserves greater than 150 per cent of maturing short and long-term debt; less than one-sixth had such coverage healing into 1997.
- 2) There have been improvements in fiscal performance, with some notable cases of governments achieving and sustaining large primary surpluses.
- 3) External balances have improved, with current accounts in most of the emerging world in surplus or modest deficit. Only 2 of the 20 largest borrowers now are running deficits in excess of 3 per cent.
- 4) Exchange rate regained are ore resilient and less fragile, and a substantial majority of the largest borrowing countries have moved to flexible, regimes, and away from the fixed-but adjustable pegs that proved so dangerous in the crises of the 1990s.
- 5) Important progress has been made in building credibility for new monetary policy requires, and inflation is generally moderate.
- 6) Governments have made major investments in recapitalising and restructuring their troubled financial systems. For example, in Asia, where some of the most severe problems were encountered, governments have spent over \$500 billion carving out problem loans and bolstering capital.
- 7) Growth rates have improved with the restoration of domestic stability and recovery in external demand. Indeed, aggregate growth currently is runni9gn at its highest rate since the on set of the crisis in 1997.
- 8) With these improvements, and generally accommodative external financial conditions, borrowing costs have fallen, capital market access was restored for many countries, and credit growth resumed. Net credit growth to sovereigns has remained moderate, however, as much of the borrowing has gone to refinancing the existing stock of debt on more favourable terms.
- 9) The market for emerging market debt has also matured. There has been more differentiation in the response of spreads, both on the way down and credit fundamentals seemed to improve, and during the recent correction.

This progress is indicative of a general increase in the sophistication and skill of economic policy makers in the emerging world, and in the quality of understanding of the benefits of macroeconomic stability and how to achieve it. Many countries benefited from the advice and financial support from the IMF and the World Bank. But the most successful were those with policy makers who were ahead of the Fund and the Bank in diagnosing and addressing their problems, rather than being dragged reluctantly toward a more credible policy stance.

These improvements have left the emerging markets as a group less vulnerable to financial crisis than they were in the id 1990s. The combination of deeper reserve cushions, stronger external positions, improved balance sheets, more flexible exchange rate required, and better inflation performance provide a very different setting from

what existed the last time the world faced a transition after a sustained period of benign financial conditions and low interest rates.

18.5 FAILURES OF THE BRETTON WOODS INSTITUTIONS

The aggregate improvements catalogued above mark substantial difference across countries and a number of areas of lingering vulnerability. Some of these are as follows:

- 1) some of the most daunting challenges are in the fiscal and public debt area, where a number of emerging market economies across different regions face very high, and in some cases still growing public sector debt levels. Average public debt burdens in the emerging world have risen to about 70 per cent of GDP, and among countries rated single B and below, the mean rises above 80 per cent.
- 2) The challenge of managing debt burden of this size is magnified by the fact that the debt structures in a number of countries are still quite vulnerable to foreign currency, liquidity and interest rate risk. The substantial share of public debt denominated in foreign currency – 70 per cent on average for the lowest rated group of borrowers – and the relatively short maturity of the debt stock mean that a relatively modest shock can produce a substantial increase in debt burdens, raising the amount of fiscal effort needed to keep the debt stock on a stable or declining path, and increasing the economy's vulnerability to a crisis.
- 3) In some countries, the fiscal trajectory is too weak to place the debt-to-GDP ratio in a sustainable path. In others, the fiscal position is strong enough to stabilise the debt dynamism but provided little buffer against adverse shocks, and very little room for fiscal policy to help cushion the effects of such a shock.
- 4) Important challenges remain in the financial area as well. In many countries, large public sector debt burdens have left banking systems highly exposed to the sovereign, constraining authorised room for manoeuvre. There are also problems in bank's corporate and consumer loans books, and a number of banking systems have also a large share of foreign currency denominated liabilities, in some cases held by non-residents.
- 5) The durability of recent improvements in external positions, which reflect weak domestic demand in many countries, is also open to question. As domestic demand strengthens, external balances could move to deficit again, which in some cases will reintroduce a greater external risk.
- 6) And in many cases, the financial exposure of the IMF and World Bank is already high.

These balance sheet challenges took a long time to develop, and they will take a long time to reverse. They are the legacy of years of past fiscal decisions, magnified by the impact of crises on growth, the exchange rate, and the financial sector. They leave an exacting set of policy challenges. They raise the risk that future shocks to domestic confidence or adverse changes in the external environment could lead to new pressures on exchange rates, or interest rates, and on the capacity of countries to fund themselves on sustainable terms. Apart from the risk of crisis, these debt levels are large enough to depress domestic investment and long-term growth

prospects. In past because of these balance sheet and debt burdens, many emerging market economies face a protracted transition before they can expect to be comfortably considered stable investment grade credits, with sufficient levels of self-insurance against external and domestic challenges to financial stability. One of the most pressing challenges for the Bretton Woods institutions is to help assist in this process of reducing vulnerability, by promoting an unwinding of these large balance sheet risks and at the same time, providing a credible form of contingent insurance for those hopefully rare circumstances when their members face extraordinary financing needs.

Check Your Progress 1

- 1) Explain how World Bank and IMF are different from each other and how they work in close coordination?

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- 2) State the major achievements of the Bretton Woods Institutions.

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- 3) Write a note on the failures of the Bretton Woods Institutions

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18.6 RATIONALE IN ERA OF GLOBALISATION AND SUGGESTIONS

In the present era of globalisation where countries have unprecedented access to international capital flows and where those who have borrowed from the Bretton Woods Institutions are doing everything they can to repay their loans, it has been suggested that the Bretton Woods Institutions should closed down, and hence the slogan “sixty is enough”. But it would be too radical a suggestions. For the reasons to be detailed below, not only there is a need for further strengthening of these institutions, there is also a new to restructure them.

18.6.1 Rationale

The rationale for the existence of the Bretton Woods institutions can be grouped in three categories as follows:

A) Dealing with Global Externalities

- i) Global financial stability and episodes of systemic risk. National monetary authorities may address some but not all of these cases. In a world of greater financial integration, less capital controls, more capital mobility, not money and fickle investors, crises in past triggered by sudden reversal of capital flows cannot be ruled out.
- ii) “Irrational” international investors’ may derive from payoff externalities (leading to runs), information asymmetries and informational cascades leading to herding behaviour.
- iii) Contagion from crisis country to other emerging markets and to advanced economies.
- iv) Warning against externalities from poor economic policies and possible need for policy coordination.
- v) External effects of liquidity runs and insolvency crises that lead to high liquidation costs.
- vi) Need for international financial supervision.
- vii) Need for mechanisms for orderly debt workouts.
- viii) Need to avoid competitive devaluations wars (that may be proxies for trade policy wars) and severe currency (financial crisis that are highly disruptive of global trade.
- ix) Ensure success of globalisation in all its forms (free trade in goods and services FDI and transfer of information and technologies across countries, increased stable capital mobility and integration, appropriate management of labour migration).

B) Market failures (even when they do not have international external effects)

- i) Self-fulfilling bank runs, government debt runs, currency crises.
- ii) Liquidation costs of liquidity or semi-liquidity crises that results in runs.
- iii) Excessive liquidation costs (i.e., the avoidable liquidation costs on top of the unavoidable ones) in insolvency crises where there are also runs.
- iv) “Conditionality lending” as a way to resolve two coordination issues: need to design appropriate policy changes based on independent and superior information (thousands of creditors cannot do it) cost – when no private creditor is large enough and risk-neutral enough in a crisis to do that (as uncoordinated creditors rush to the exist) conditionality lending is a form on “delegated monitoring and coordination mechanisms” when there are “multiple principles” for the debtor agent.
- v) Reducing the adjustment costs (need for how adjustment and stock adjustment and costly macro/structural reforms) for countries with serious underperformance and policy shortcomings.

- vi) Need to actively coordinate debtor and creditors action in crisis management (resolution because of collective action problems (rush to exists, such to courthouse, holdout / tree rider problems) between creditors and between the debtors and its creditors including IMF pushing for appropriate policy regime changes.
- vii) Possible provision of lender of last resort support to domestic banking systems that are informally or formally ‘dollarised’. As more countries ‘dollarise’, ‘euroise’, join monetary and currency unions or are informally dollarised, domestic monetary authorities cannot provide such lender or last resort support.

C) Domestic Policy Failures

- i) There is too much emphasis on “ownership” ownership of bad policies can lead to disasters. So, at times, the Fund and the Bank will need to be “paternalistic” and tell a country that the policies are unsustainable, that its debt is unsustainable and that its exchange rate regime is unsustainable. Subject to the caveat that some basic ownership is necessary to ensure that an IMF Programme is actually implemented, the IMF should not shy away from being paternalistic when necessary.
- ii) But the Fund and the Bank should be careful about who are the “reformers” and who are the “vested interests”. In countries with very unequal wealth and income distributions, the oligarchic elites may pursue their own private and corrupt interests.
- iii) Going against vested interest and supporting reformers may mean to choose socially progressive reformers. Those advocating reforms that might address some inequality and poverty at times are not defined as “reformers” even though they are taking on vested interest. Vested interests that secure their interests in other ways often have not gotten the some security from the institutions.

Given these different externalities and market failures. The Bretton woods institutions have many important roles as follows:

- Ensure international monetary and macro stability that is essential for economic growth.
- Ensure global financial stability.
- Provide bilateral and multi-lateral surveillance and tools for crisis prevention.
- Provide lending to countries in financial difficulty or crisis.
- Support macro stability, and thus long run growth, in lower income countries.

18.6.2 Suggestions

For the last 60 years the Bretton Woods institutions have played an essential role in ensuring global financial stability and fostering economic growth and development. Further, as would be clear from the above discussion, these institutions are equally important even now. What is required is a strategic review of their functions and roles to identify the areas where these institutions can be constructively reformed to ensure that they maintain the crucial and essential roles that they have played until now. To this end, following suggestions in brief, have been made.

1) **Facilitating Restructurings**

There has been some progress in the last few years in efforts to improve the framework for sovereign restructurings. In particular, collective action clauses have become the market standard where emerging market governments issue debt under foreign law. The Bretton Woods institutions should be willing to lend to a sovereign that is in default to its private creditors only when two conditions have been established.

One, the country must commit to a credible medium-term adjustment programme, one that offers that prospect of a successful restructuring and a reasonably early return to the capital markets. This has to be established upfront for any restructuring effort to work. Commitment to a credible adjustment path that offers the reasonable prospect of a return to financial visibility and growth is the necessary foundation for engagement by the creditors in a restructuring process. Without that, there is little basis for meaningful engagement.

Two, before an institution can commit its support, the country must develop, in consultation with its advisors, and outline to the institution and its creditors, a credible and monitorable framework for cooperatively achieving a viable debt restructuring, one that leaves the country with a sustainable debt burden. The issues of appropriate adjustment and appropriate broad terms of proposed restructuring are closely intertwined and need to be assessed in tandem. For the BW institution, it should be an essential prerequisite that the country demonstrate at the outset that its approach has credible prospects for enlisting broad credit concurrence, and for being consistent with country's macroeconomic framework and payment prospects.

2) **Strengthening the Financial Instruments**

With this in view, following suggestions can be made:

- i) Finance must be conditioned on a policy framework strong enough and timely enough to restore confidence. An institution's resources cannot compensate for a lack of policy credibility, and lending official resources to fund an inadequate policy efforts may make the situation worse.
- ii) The scale of finance provided has to be calibrated to the needs, and the needs can be substantial in today's world. The BW institutions can only fill part of the gap, but there have to be able to fill a credible share of the gap if these have to play a successful part in catalysing other resources to flow.
- iii) Flexibility to structure programmes appropriate to the circumstances and the borrower's policy effort is essential. The BW institutions need to be able to substantially frontload financial packages, when this is warranted. Making available small tranches of resources over the life of a programme does little to address the realities of open emerging market economies facing liquidity problems. Rather than the classic staircase pattern of disbursements, the institutions should consider, in some cases, providing a larger up front tranche that floats and is available if stress materialises and policy is responding appropriately.
- iv) The BW institutions should stand ready to support countries in pursuing reasonable restructuring proposals when narrated by the circumstances. Official financial resources in that context can be helpful in meeting some targeted needs.
- v) The institutions need a more credible capacity to withstand arrears, so that these do not face the reality or the perception that these can be induced to accept weak programmes only to allow them to refinance their exposure.

3) **Changing the Surveillance Framework**

Part of the challenge entails reorienting surveillance, the process through which the BW institutions policy advice is delivered, to make it more effective. The surveillance features of today has a number of features that make it poorly suited to a small open emerging market economy that fragile credibility, a limited buffer against shocks, and considerable exposure to a rapidly changing economic and financial environment. Surveillance does not provide a meaningful check on *ex ante* policies, and resources are only made available when the financial need is acute. Access to supplemental resources on a precautionary or contingent basis could make a critical difference in preventing short-term liquidity crisis from becoming full-scale solvency problems leading to default. Of course, access to such contingent financing should be limited to countries whose policies were judged reasonably sustainable, and consistent with a reduction in balance sheet risks over time. With an enhanced surveillance framework designed to help keep policy on a stronger path that does reduce risk over time, and with contingent finance that could be mobilised quickly, the institutions would be better positioned to contain the risk of deeper financial crisis.

4) **Market-Friendly Reforms**

One main shortcoming of present development cooperation is that recipients of development cooperation is that recipients of development finance are denied any form of protection usual in all other cases. This shows in cases of violation of membership rights as well as regarding professional best practice. Damage done by grave negligence must always be compensated unless done in the context of development cooperation. Donors and multilateral institutions are totally exempt from any liability. The increased role of the BW institutions in international capital markets since 1982 contrasts sharply with a total lack of financial accountability. They may and often do gain institutionally and financially from crisis or from their own errors and failures, even if they cause damages by grave negligence. Another loan may be granted to repair damages done by the first loan, increasing the institutions income stream – a severe moral hazard problem and an economically totally perverted incentive system.

International financial institutions should be held financially accountable, differentiating between programmes and projects. To increase BW institutions efficiency and to improve their role in capital markets, market incentives must be brought to bear. The international public sector must become financially accountable for their own errors in the same way as consultants are liable to pay damage compensation if / when negligence on their part causes damage.

5) **Emulating the Private Sector**

The principle of corporate governance needs to be applied to the BW institutions.

IMF

The most important issue is how to reform the countries quotas in the IMF and the chairs in the Executive Board of the fund to provide greater representation to Asia and Africa. Given the growing roles of Asia in the global economies, Asian policy makers have correctly complained about a system of distribution of power within the IMF that does not recognise their growing role and, in part, they have developed institutions for Asian financial cooperation as a reaction to their frustration for the lack of recognition of their growing global role. There is room for a creative solution: Unify the Chairs currently held by the Euro members, thus reducing the number of European Executive Directors, reallocate the existing quotas, reduce the quotas of

the European countries to reflect the change in important and power of other regions. Thus, there is now room – and meaningful livelihood for some creative reform that will deliver a more representative IMF in the 21st Century.

Check Your Progress 2

- 1) Explain the need for Bretton Woods Institutions in this age of globalisation.
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- 2) What should be the role of Bretton Woods Institutions in the present times?
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- 3) Make suggestions to improve the working of the Bretton Woods Institutions.
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18.7 INTERNATIONAL DEVELOPMENT ASSOCIATION (IDA) AND INTERNATIONAL FINANCE CORPORATION (IFC)

To end this unit on Bretton Woods Institutions, we give a brief profile of the working of the IDA and IFC, two associates institutions under the World Bank umbrella.

18.7.1 Working of IDA

IDA is an associate of IBRD. It was established in 1960 to provide ‘soft loans’ to economically sound project which creates ‘social capital’ such as the construction of roads and bridges, slum clearance and urban development. The projects taken by the IDA are such that fall under the category of high development priority due to their benefit to the development of the area concerned, but the returns from the projects are not sufficient to pay the high rates of interest on borrowings. The IDA provides loans for such projects interest-free and for longer periods. Therefore, IDA is often referred to as the ‘soft loan window’ of the World Bank.

The IDA extended assistance to high priority projects in the member-countries. The finance may be made available to the member-governments or to the private enterprises. Lending to private enterprises may be made without government guarantees. It also cooperated with other international institutions and member-countries in providing financial and technical assistance to the less-developed countries.

The financial assistance of the IDA has some special features.

- The credit is interest-free. Only a small service charge of 0.75% per annum is payable on amount withdrawn and outstanding to cover administrative expenses.
- Repayment period is long-extending over 50 years. There is an initial moratorium for 10 years and the amount borrowed is repayable in the next 40 years.
- IDA finances not only the foreign exchange component but also a part of the domestic cost.
- The credit can also be repaid in the local currencies of borrowing countries. Thus, the repayment of loan does not burden the balance of payments of the country.
- Only the poorest among the poor countries are eligible for assistance.

All members of the IBRD are eligible to become members of the IDA. The members are grouped into two. Part I consists of industrially developed countries whose subscription can be freely used or exchanged for other currencies by the IDA. Part II lists countries who are required to contribute 10% of their subscription in the form of other currencies and the rest of their own currencies. Contributions in the form of national currencies by these countries are not to be used by the IDA for conversion to other currencies or for financing exports from these countries without the consent of the country concerned.

IDA has been a blessing for the developing countries to whom the credit from the IDA has largely gone. The agency brings significant amounts of investment to the poorest countries on much easier terms than would otherwise be attainable. Importantly, it also serves to separate out the worst risk, protecting the World Bank's treasured A bond rating and thus allowing it to borrow in world credit market at the most favourable terms. In keeping with the objectives, most of the assistance has gone to high development priority projects which could not get finance from other sources.

18.7.2 Working of IFC

The IBRD loans are available only to member-country governments or with the guarantee of member-country governments. Further, IBRD can only make a loan but it cannot participate in the equity of the financed project. IFC was established in 1950 with the specific purpose of financing private enterprise. It is an affiliate of the IBRD. The Board of Governors of the IBRD also constitute the Board of Governors of the IFC. But it is a separate entity with funds kept separate from those of the IBRD.

The purpose of the IFC is to further economic development by encouraging growth of private enterprise in member-countries, particularly in the less-developed areas, thus supplementing the activities of the IBRD. The IFC, therefore:

- Invests in private enterprise in member countries, in association with private investors and without government guarantee, in cases where sufficient private capital is not available on reasonable terms.
- Seek to bring together investment opportunities, private capital of both foreign and domestic origin, and experienced management; and

The IFC makes advances in the form of long-term loans or invests in the equity shares in a wide variety of productive private enterprises in developing countries. It particularly encourages joint ventures between developed and developing countries, the technical skill available with the former combining with the resources available with the latter. The project which IFC proposes to assist should be economically viable one and beneficial to the economy of the member-country. IFC's investment normally does not exceed 40% of the total investment of the enterprise. In case of its investment by equity contribution, it does not exceed 25% of the share capital. The interest charged on advances varies depending upon the proposal and status of the borrower.

The resources of the IFC consist of capital contributed by its members. It can also borrow from the World Bank for the purpose of lending. It can also float its own loans in world capital markets.

The IFC had a slow beginning and much of its assistance was concentrated in Latin and Central America Countries. But in recent years it has diversified its area of operation and many developing countries stand benefited.

Check Your Progress 3

- 1) How is IDA different from / related to IBRD?

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- 2) Examine the Working of the International Development Association.

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- 3) Examine the working of the International Finance Corporation.

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18.8 LET US SUM UP

For the last 60 years the Bretton Woods institutions have played and still play an essential role in ensuring global financial stability and fostering economic growth and development. A strategic review of their functions and roles is thus important to ensure that they maintain – in the next 60 years – the crucial and essential roles that have played until now.

18.9 KEY WORDS

Externalities	: These are variously known as external economies and diseconomies, spill over and neighbour effects. Externalities involve an inter-dependence of utility and / or production functions. A beneficial externality arises where an externality – generating activity raises the production or utility of the externally-affected party. An external diseconomy is where the externality-generating activity lowers the production or utility of the externally – affected party.
Market Failures	: The inability of a system of private markets to provide certain goods either at all or at the most desirable or ‘optimum’ level.
International Payments Systems	: A general term referring to the way in which international financial transactions are carried out, that is payments between residents of different countries who hold different domestic currencies.
Special Drawing Rights	: It is an accounting creation without any backing, which, subject to a variety of conditions, debtor countries may use to settle debts.
Conditionalities	: The terms at which loans are extended by the IMF.

18.10 SOME USEFUL BOOKS

Grabbe, J. Orlin, *International Financial Markets* (Prentice Hall, New Jersey)

Dhingra, Ishwar C (2007) *The Indian Economy: Environment and Policy* (Sultan Chand, New Delhi,).

Soderston B. and Geoffery Read, *International Economics*, (Mac Millan, London).

Salvatore Dominick, *International Economics* (Prentice Hall, New Jersey)

Bhagwati, J.N., *Dependence and Inter-dependence* (Cambridge, M.I.T).

<http://www.imf.org>

18.11 ANSWERS/HINTS TO CHECK YOUR PROGRESS EXERCISES

Check Your Progress 1

- 1) See Sub-section 18.3.2.
- 2) See Section 18.4
- 3) See Section 18.5

Check Your Progress 2

- 1) See Section 18.6
- 2) See Sub-section 18.6.1
- 3) See Sub-section 18.6.2

Check Your Progress 3

- 1) See Sub-section 18.7.1
- 2) See Sub-section 1.8.7.1
- 3) See Sub-section 18.7.2

UNIT 19 REGIONAL FINANCIAL INSTITUTIONS

Structure

- 19.0 Objectives
- 19.1 Introduction
- 19.2 The Theory of Customs Union
- 19.3 Currency Unions and Optimum Currency Areas
- 19.4 Growth of Regional Financial Institutions
- 19.5 Europe: A Case Study
- 19.6 Let Us Sum Up
- 19.7 Key Words
- 19.8 Some Useful Books
- 19.9 Answers/Hints to Check Your Progress Exercises

19.0 OBJECTIVES

After going through the Unit, you will be able to:

- define and explain the working of customs unions currency areas;
- define and explain the working of optimum currency areas;
- analyse the growth of regional financial institutions; and
- describe and assess the development of the European arrangements regarding the evolution of customs union, and later, currency unions.

19.1 INTRODUCTION

You have read about regional international trading blocs in Block 5 Course MEC 007 International Trade and Finance. This unit deals with regional financial institutions which are institutions working in a group of nations. Regional financial institutions are institutions that have financial dealings in a certain region rather than at a global level. But we explore in a greater part of the unit how a group of nations comes together to engage in foreign trade and international financial dealings among each other using arrangements that may be thought to be substitutes for the fixed exchange rate system that you studied in Unit 17.

We will explain the theory of customs unions in the next section. These unions are basically arrangements where a group of nations do away with tariff and non-tariff barriers among themselves but apply these to countries outside the group. The subsequent section deals with currency unions and optimum currency areas. These are areas where the member countries agree to share a common currency. The monetary or currency union is an extension of the fixed exchange rate that seeks to avoid the instability associated with the fixed exchange rate system. The section after that deals with regional financial institutions, which are financial institutions that

lend at the level of a few nations, or one continent. An example is the Asian Development Bank (ADB). The final section discusses the evolution of Europe in the post-World War II period from being a customs union to moving towards a monetary union with a common currency. This section is an application of sections 19.2 and 19.3 on customs union and currency unions, respectively.

19.2 THE THEORY OF CUSTOMS UNION

A customs union is an association of two or more countries to encourage trade. The countries making such an arrangement agree to eliminate tariffs and other restrictive regulations on trade among them. It is a discriminating trade arrangement since the liberalisation only includes the countries that are members of the customs union and they formulate and administer a common foreign trade policy in regard to tariffs and other trade restrictions against third countries.

The best-known customs unions have included the Zollverein, which was created by Bismark, Benelux and the EEC, which later came to be called the EU. The Zollverein was formed by German states in the 1830's. These states became the German nation in 1871. Belgium, the Netherlands and Luxembourg established Benelux in the 1940's. Belgium, France, Italy, Luxembourg, the Netherlands and West Germany set up the EU in 1957. We will discuss about the European case in greater detail in Section 19.5.

The first systematic analysis of customs union was provided by Jacob Viner. He looked at the situation for a group of countries before and after they joined the union. In what circumstances would countries gain by forming a customs union? How will trade patterns and resource allocation be affected? According to Viner, after the formation of the union, some member would be importing from others but which it formerly did not import because the price of the protected domestic price of the product was lower than the import price. With the formation of the union, protection to domestic industry would be removed. There will be a shift in the locus of production from a high cost to a low cost point. This would be appreciated by those who champion free trade. Viner called this outcome *trade creation*. There could be a second kind of effect of the formation of customs union, according to Viner. After the formation of the union, there may be commodities which a member would be importing from some other member, which it earlier used to import from a low-cost *third* country, because that was the cheapest source of supply, even after payment of duty. After the union, this same product may be purchased from another member of the union. The shift of production in this case is not now between two member countries but between a low-cost non-member country and high-cost member country. This kind of effect Viner called *trade diversion*.

According to Viner, when trade creation is dominant and trade diversion not so prominent, the formation of the union raises the collective welfare of its members. Some member may experience a loss, but the joint welfare of others will outweigh the loss. Moreover, the non-member countries may experience some welfare loss, but the welfare of the members will outweigh that loss. On the other hand, if trade diversion is dominant, a customs union may reduce the welfare of its members.

Viner's analysis had three limitations. First, he did not show how to deal with a trade-off between trade creation and trade diversion. Secondly, he assumed a case of constant returns to scale. Finally, he considered only production effects, and did not analyse consumption effects which modern tariff analysis explicitly brings into

the picture. Traditional customs union theory builds on relatively strict assumptions such as perfect competition in commodity and factor markets and hence it is often referred to as orthodox customs union theory. It also only deals with the static welfare effects of a customs union. It has both positive and negative welfare effects, compared to a situation in which every member state practices protectionism. Therefore no conclusion can be drawn in advance as to the net welfare result of a customs union. The term 'orthodox customs union theory' is due to the relatively strict assumptions of this theory, i.e., perfect competition in the commodity market and factor markets, perfect factor mobility within individual countries but not among the countries, foreign trade equilibrium and full employment. The opportunity cost in production is reflected in the relative commodity prices in each country and transport costs are not included since tariffs are assumed to be the only kind of international trade barrier.

Later theories have attempted to deal with these limitations of Viner's theories. Customs union theories can be analysed in the same way as partial equilibrium analysis of the effects of tariffs. We now compare customs union with free trade zones. Both customs union and free trade zones are examples of **preferential trading agreements** under which member countries apply lower tariffs on each other's goods than on the same goods coming from other countries. In a customs union, the countries must agree on the tariff rates. In a free trade area, on the other hand, each country's goods can be shipped to the other without tariffs, but in which each member country sets tariffs against the outside world *independently*. The North American Free Trade Agreement (NAFTA) is a free trade agreement between the US, Mexico and Canada. Canada and Mexico need not agree, for example, on tariff rate on electronics goods from Japan. The European Union is a customs union. Free trade area is politically simple but administratively complex while a custom union is the opposite. For example, tariff administration is easy in a customs union. Goods must pay tariffs when they cross the border of the union but can be freely shipped from there onward.

Check Your Progress 1

- 1) What is a preferential trading agreement?

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- 2) Explain the difference between trade creation and trade diversion effect of a customs union.

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- 3) Bring out the difference between customs union and a free trade area.

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19.3 CURRENCY UNIONS AND OPTIMUM CURRENCY AREAS

You have studied about the relative merits of fixed and flexible exchange rates in unit 17. One alternative to fixed exchange rates is for a group of currencies to form a common currency. This Section explains the working of monetary unions and common currency areas. The Section also examines the case for and against optimum currency areas. Countries are facing external economic shocks all the time. By changing its exchange rate, a country can lessen the disruptive effect on its economy. If the country has a flexible exchange rate policy, it can have some potentially harmful effects, like making prices volatile, and governments not being able to check inflation. So a country might like to get the same type of benefits that are conferred by the fixed exchange rate system, and avoid the rigidities at the same time. This is possible through an optimum currency area. The basic theory of currency unions was put forward by Robert Mundell, who later went on to win a Nobel Prize for his work

A country's costs and benefits from joining a fixed-exchange area depend on how well integrated its economy is with its potential partners. The theory of optimum currency areas suggests that fixed exchange rates are most appropriate for areas closely integrated through international trade and factor movements. A major benefit of fixed rates is that they simplify economic calculations and provide a more predictable basis for decisions that involve international transactions as compared to floating rates. The monetary efficiency gain from joining the fixed exchange rate system is the comparative saving from avoiding the uncertainty and transactions costs that arise from floating exchange rates. A high degree of economic integration between a country and a fixed-exchange rate area *amplifies* the monetary efficiency *gain* that accrues to the country when it pegs its exchange rate against the area's currencies. Another reason why high integration with a fixed exchange area increases a country's benefits from joining the area is economic integration leads to international price convergence and hence lessens the scope for independent variation in the pegging country's price level.

Membership in an exchange area may involve costs as well, even when the area has low inflation. These costs arise because a country joining an exchange rate area gives up its ability to use the exchange rate and monetary policy for the purpose of stabilising output and employment. This economic stability loss from joining like its benefits from joining is related to the country's economic integration with its exchange rate partners. Now, a basic result is that a high degree of economic integration between a country and the fixed exchange rate area it joins *reduces* the resulting economic stability loss due to output market disturbances. This finding as well as the previous one about high degree of economic integration increasing the benefits of a country joining a fixed-exchange rate area explains the existence of optimum currency

area which is a region with economies closely linked by trade in goods and services and factor mobility.

An **optimum currency area (OCA)**, also known as an **optimal currency region (OCR)**, is a geographical region in which it would maximize economic efficiency to have the entire region share a single currency. It describes the optimal characteristics for the merger of currencies or the creation of a new currency. An optimal currency area may often be larger than a country. For instance, part of the rationale behind the creation of the euro was that the individual countries of Europe did not each form an optimal currency area, but that Europe as a whole does form an optimal currency area.

The main characteristics of an optimum currency area are:

- 1) Labour should have free mobility across the region. This includes physical ability to travel (visas, worker's rights, etc.), lack of cultural barriers to free movement (such as different languages) and institutional arrangements (such as the ability to have pension transferred and to the new region).
- 2) Openness with capital mobility and price and wage flexibility across the region. This is so that the market forces of demand and supply automatically distribute money and goods to where they are needed. In practice this does not work perfectly as there is no true wage flexibility.

There should be an automatic fiscal transfer mechanism to redistribute money to areas/sectors which have been adversely affected by the first two characteristics. This usually takes the form of taxation redistribution to less developed areas of a country/region. This policy, though theoretically accepted, is politically difficult to implement as the better-off regions rarely give up their revenue easily.

Additional criteria that have been suggested for a region to be called an OCA by some economists are: there should be (a) production diversification (b) homogeneous preferences and (c) commonality of objectives. The classical case for optimum currency areas assumes not only a similarity among participating countries, but also a high level of economic integration among participating countries. This theory has been most frequently applied in recent years to the euro and the European Union. By the above criteria the European Union does not constitute an Optimal Currency Area and therefore the Euro should not be a successful union of currencies. Although the developing world's experience with monetary unions has been neither abundant nor successful, European monetary integration has led to some initiatives for forming monetary unions in the developing world. The initiative taken by the members of the Gulf Cooperation Council stands out in this regard.

Check Your Progress 2

- 1) Explain why country that is already closely economically integrated with a fixed-exchange rate area will gain from joining the area as a member.

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- 2) Explain what an optimum currency area means. How does it work?

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- 3) What are the two main characteristics of an optimum currency area?

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19.4 GROWTH OF REGIONAL FINANCIAL INSTITUTIONS

We find many levels of groupings of nations in the international arena. Groups of countries that share borders often have semi-permanent cooperation agreements on immigration and customs and possess institutions that implement these. Other groupings of countries come together on the basis of and to advance an ethnic, a geographical and or a cultural identity. Institutions like the UN, the World Bank and IMF are global institutions. You studied about global Bretton Woods institutions like the World Bank and IMF in the previous unit.

There is a particular type of grouping that is relatively large in terms of country coverage without being global, and one that deploys primarily financial instruments to advance its objectives. These are the Regional Financial Institutions (RFI's). Regional financial institutions are institutions that have financial dealings in a certain region rather than at a global level. For instance, the Asia Development Bank operates to assist financially countries in Asia and the Pacific. An important characteristic of these institutions is that both rich and poor countries are their members. The rich nations are usually donors and the poor the recipients. In other words, these institutions are primarily designed to be agents of development assistance. In some ways, the, RFI's are smaller scale versions of fully global financial institutions (GFIs), particularly the World Bank. The operations of the RFI's and GFI's may sometimes overlap in some countries.

There can exist, theoretically and actually, groups of firms, and groups of countries. There sometimes arise in these groupings, economies of scale as well as economies of scope. The size of the institutions will be determined by marginal costs and benefits of size, which will in turn depend on the specifics of the socioeconomic situation being discussed. Taking the perspective of costs and benefits, of scale and scope, we can ask as to the rationale for the co-existence of RFI's and GFI's, especially when 'development assistance resources' may be scarce. If there is such a rationale, is the current mix of RFI's and GFI's optimal? The issue is division of labour between RFI's and GFI's, and how both types of institutions can increase their effectiveness.

There are mixed motives for the donor countries to provide development assistance to developing nations. While a desire for poverty alleviation may genuinely be present, there is also narrow self interest, as is sometimes seen in the case of tied aid. There are also foreign policy interests. But we can still look at the advantages and disadvantages of alternative institutional arrangements for development assistance. One case is bilateral assistance. In this case the donor country's 'taxpayers' can closely monitor their aid in the developing country. The disadvantages also arise from this same source—domestic political processes in the donor country, and domestic distributional struggles, affect and influence the nature and composition of development assistance. This is seen in the various pressures that come on a government to tie its aid to purchases from its own suppliers.

We turn to the issue of whether a group of donor nations should come together multilaterally. In principle, a pooling of resources in a rich donors' group should have considerable cost advantages. However, pooling of countries in turn introduces the problem of differences in preferences of the different members on how the resources should be used. Whatever consensus is reached, it will always be unsatisfactory to some countries' preferences as donors. The cost advantages therefore have to be balanced against this disadvantage. Therefore, a rational response for each donor country will be to diversify, to have some of its development assistance flow through bilateral channels and some through channels that group together rich country donors. This argument has not as yet provided a rationale for RFI's, since it discusses groupings of donors, not groupings of recipients. What are the costs and benefits of grouping recipients into groups that are defined by geographical region? The cleanest argument comes from a consideration of cross-border externalities and multi-country public goods. When development in or actions by one country have an impact on other countries, an impact that is not mediated by competitive markets, the presence of such an externality can lead to sub optimal policy outcomes for the group of countries encompassed by that externality.

The above argument suggests a demarcation of tasks: regional externalities to be dealt with by regional institutions, global externalities by global ones. In other words, RFI's should supply regional public goods (RPG's), and GFI's should supply global public goods (GPG's). Of course the division is not clear-cut.

There are five policy suggestions that have been made regarding regional financial institutions. First, the responsibility and resources for region specific public goods should be gradually and increasingly shifted to the RFI's. To the extent that the RFI's do not have the capacity to deliver on these just yet, a purposive programme of building up these capacities should be developed. Second, global issues such as green house gases, financial contagion, global spread of diseases, etc., should remain the domain of global institutions. But these may not be explicitly financial institutions.

Third, on country specific operations there should be a presumption in favour of donor resources flowing through RFI's rather than the World Bank. This does not necessarily mean that the World Bank end country-specific operations. Fourth, there should be a presumption that the lead role in interacting with a government in developing and monitoring conditionality should fall to the RFI's rather than the GFI's. And finally, in certain situations, a case could be made for *sub*-regional financial institutions for further improving the division of labour.

Regional development financing arrangements have been of three basic types.

The oldest and best-developed type is multilateral development banks and related

multilateral financial institutions. These institutions are present in all regions, although with different coverage, structures, and priorities. A second type, which is usually used by the European Union, is fiscal transfers with explicit redistributive regional objectives. A third and more novel type is the development of regional bond markets; East Asian countries have taken the most significant steps in this regard.

Regional financial cooperation faces significant challenges, which must not be underestimated. They relate to the viability and long-term sustainability of the arrangements that are created, and involve three major issues: the capacity of a given group of developing countries to supply the relevant financial services; the need to guarantee that strong regional institutions are developed; and an equitable distribution of the benefits of regional integration.

19.5 EUROPE: A CASE STUDY

Let us now see how events unfolded over the decades in Europe that led to monetary unification in terms of a single currency and single central bank. At the very beginning Europe undertook steps in this direction by forming a customs union. European attempts at regional integration started soon after the Second World War when there was a common realisation among these countries of the need to rebuild their war-affected economies. Moreover, the United States through the Marshall Plan for the reconstruction of Europe. The US urged the European governments to combine their economic and political resources. At first, Europeans adopted a sectoral approach. The European coal and Steel Community was created, freeing trade in coal and steel. Then efforts were directed towards the creation of a full – fledged customs union, an arrangement under which all trade barriers among these countries would be abolished, and a common external tariff for other countries would be adopted. In 1957, six countries (Belgium, France, Germany, Italy, Luxembourg and the Netherlands) signed the treaty of Rome, establishing the common market in 1958. Monetary cooperation in Western Europe began before the creation of the common market in 1958 but efforts in this direction were stepped up in the later period. The customs union was completed in 1968. In 1973, Britain was admitted to the EEC. The EEC adopted a Common Agricultural Policy (CAP) in 1968, setting uniform prices for farm products and imposing variable levies on imports.

Current account convertibility came early (in 1958, coinciding with the launch of the Common Market), capital account liberalisation came late, and was part of a gradual process that did not culminate in the collective removal of capital controls until 1990. This was soon followed by a major crisis in 1992. It thus became clear that exchange rate stability required a full-fledged movement toward monetary union. This was combined with the Stability and Growth Pact, which established explicit fiscal rules and convergence criteria.

Europe's move towards a common currency area started in the late 1960s when the Bretton Woods system started showing problems and there were currency crises. In 1969, European leaders met at The Hague and appointed Pierre Werner, Prime Minister and finance minister of Luxemburg to head a committee that would outline concrete steps for eliminating intra-Europe exchange rates, lowering trade barriers and centralising EU monetary policies. The Werner Report was adopted in 1971. In March 1979 was formed the European Monetary System. It was a mutually pegged exchange rate system consisting of eight members originally: France, Germany, Italy, Belgium, Denmark, Ireland, Luxembourg, and The Netherlands. This system worked to restrict the exchange rates of participating currencies within

specified fluctuating margins. The EMS went through periodic currency realignments. Eleven realignments occurred between 1979 and 1987. events of 1990 when reunification of eastern and western Germany took place. This led to huge spending and fiscal expansion by Germany as well as borrowing and there was high inflation in that country. The German Central Bank, the Bundesbank raised interest rates to stem inflation. Other EMS countries like France, Italy and Britain were not growing fast, and they did not want to raise interest rates as that might have lowered real investment and pushed their economies into recession. They also did not want to devalue their currencies. The result was a series of speculative attacks on the EMS exchange parities. By 1993 the EMS was forced to retreat to very wide bands which stayed till 1999.

The process of developing a common market that was started in 1957 when the EU (then called EEC) formed the customs union, was still incomplete in the late 1980s. There were government imposed standards and licence requirements in some countries. There were significant barriers to factor movements. In June 1985, the EU's executive body, the European Commission decided to work towards removing all barriers to trade and capital and labour movements by 1992.

The early EMS had frequent currency realignments and widespread government control over capital movements. This led to significant manoeuvring for national monetary policies. In 1989, a committee headed by Jacques Delors, president of EC, recommended a transition to an economic and monetary union (EMU) and eventually to a single currency. This was followed by a meeting of the leaders of the EU on December 10, 1991, at the Dutch city of Maastricht and a decision there to place the EU on the path to EMU.

The EU countries moved away from the EMS towards the more ambitious goal of a single shared currency for four reasons. First, it was believed that a single EU currency would produce a greater degree of European market integration than fixed exchange rates by removing the threat of EMS currency realignments and removing the costs of currency conversion. The single European currency was seen as a necessary complement to the 1992 plan for unifying EU markets into a single, continent-sized market. Secondly, Germany's actions after 1990 and its position made some countries feel that EU's goals were being substituted by Germany's goals at the cost of their benefits. They felt the need of a European Central Bank. Third, given the wide freedom of capital movements within the EU, it seemed not a good idea to keep national currencies with fixed parities; rather it was felt that a unified, single currency would be better. if the goal was to combine permanently fixed exchange rates with freedom of capital movements, a single currency was the optimal solution. Finally, it was hoped by leaders of EU, the participants in the Maastricht Treaty, that the Treaty's provisions would guarantee the political stability of Europe. A single currency was seen as signifying greater political cooperation as well.

The Euro is the name that has been given to common official currency unit of 12 European countries, namely, Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxemburg, Portugal, Spain, and The Netherlands. These 12 countries along with the three other countries who are not part of the official currency unit of the euro, namely, Britain, Denmark and Sweden as you know constitute the European Monetary Union. These three countries are not part of the euro. The euro was formally introduced on January 1, 1999. At that time Greece was not a member, and joined two years later. During the period between January 1, 1999 and December

31, 2001, the respective national currencies of these countries continued to be legal tender, but their governments issued debt in euro.

The birth of the euro resulted in fixed exchange rates between all European Monetary Union nations. Not only did the countries have a fixed exchange rates system; they even had a common currency and a common Central bank. They thus gave up more sovereignty than a normal fixed rate regime entails. The European Central Bank was inaugurated on June 30, 1998, with its headquarters in Frankfurt. This Bank replaced the European Monetary institute.

Check Your Progress 3

- 1) What is the basis you would suggest to get the optimal mix of activities between Regional Financial Institutions and Global Financial Institutions?
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- 2) What have been the basic types of regional financial arrangements?
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- 3) Briefly state the basic reasons why the EU nations decided to move away from the EMS to the goal of a shared single currency?
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19.6 LET US SUM UP

In this unit, we continued our discussion of international financial relations that we had started in Unit 17. The unit discussed trading and financial relations for a group of nations who trade together as a block. The unit began with the theory of customs union. The basic assumptions were clearly stated and the workings of these unions were discussed. The advantages and disadvantages of these unions were assessed. Subsequently the unit went on to discuss the theory of optimum currency areas. The economic gains for the members were discussed and the political implications were touched upon.

The unit then discussed in great detail the history of the European experience, how Europe experienced a common market, a customs union, and later made moves towards an optimum currency area, and subsequently, made a move towards a common currency and common central bank. Various evolving arrangements and agreements in this regard were described. Finally, the unit did a regional version of the analysis of the previous unit. While Unit 18 talked of Bretton Woods institutions, the present unit talked of regional financial institutions. We saw why they exist and what functions they perform, and to what extent they are able to help nations that deal with these institutions.

19.7 KEY WORDS

Currency Area	: An area where a group of countries share the same currency.
Customs Union	: A customs union is an association of two or more countries to encourage trade through an arrangement by which they agree to eliminate tariffs and other restrictive regulations on trade among them.
Free Trade Area	: in a free trade area, each country's goods can be shipped to the other without tariffs, but in which each member country sets tariffs against the outside world independently.
Monetary Efficiency Gain	: it is the gain arising from joining the fixed exchange rate system. The gain is in the comparative saving from avoiding the uncertainty and transactions costs that arise from floating exchange rates.
Monetary Union	: an arrangement where a group of countries agree to conduct monetary policy through a common central bank, and have a single currency.

19.8 SOME USEFUL BOOKS

Coyle, B.(2001) *Foreign Exchange Markets*, Glenlake Publishing Company, Chicago.

Kenen, Peter B. (1994) *The International Economy*, Cambridge University Press, Cambridge.

Levin, Jay H. (2000) *A Guide to the Euro*, Houghton Mifflin, Boston

19.9 ANSWERS/HINTS TO CHECK YOUR PROGRESS EXERCISES

Check Your Progress 1

- 1) See Section 19.2 and answer
- 2) See Section 19.2 and answer
- 3) See Section 19.2 and answer

Check Your Progress 2

- 1) See Section 19.3 and answer
- 2) See Section 19.3 and answer
- 3) See Section 19.3 and answer

Check Your Progress 3

- 1) See Section 19.4 and answer
- 2) See Section 19.4 and answer
- 3) See Section 19.5 and answer